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In the Supreme Court of the United States

October Term, 1957

SELECT THEATRES CORPORATION, PETITIONER

v.

JAMES W. JOHNSON, Collector of Internal Revenue

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the District Court (Pet. 30-55), is reported at 145 F. Supp. 583. The opinion of the Court of Appeals (Pet. 56-57) is reported at 249 F. 2d 655.

JURISDICTION

The judgment of the Court of Appeals was entered on December 3, 1957. (Pet. 56-57.) Taxpayer's petition for a writ of certiorari was filed on February 11, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, as both courts below held, taxpayer did not acquire its assets pursuant to a tax-free reorganization under Section 112(b)(4) and (i) of the Revenue Act of 1932, and hence was required to use the cost to it rather than a substituted basis for the assets in computing its equity invested capital for excess profits tax purposes.

STATUTES INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * *

(4) *Same — Gain of Corporation.* — No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * *

(i) *Definition of Reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least

a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

* * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

* * * *

Internal Revenue Code of 1939:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 718 [As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * *

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for

determining loss upon sale or exchange.
* * *

* * * *

(26 U.S.C. 1952 ed., Sec. 718.)

STATEMENT

The material facts, as found by the District Court (Pet. 30-43), may be summarized as follows:

In 1924 Shubert Theatre Corporation (hereafter called Shubert) was organized to take over theatrical enterprises theretofore conducted by Messrs. Sam S., Lee, and J. J. Shubert. With the onset of the depression in 1929, Shubert sustained increasing losses and on October 20, 1931, equity receivership proceedings were instituted, Lee Shubert being appointed one of the receivers. As of October 20, 1931, Shubert's liabilities consisted of $6,360,000 6% gold debentures due June 15, 1942, plus accumulated interest thereon of $323,000; $1,158,000 in notes and accounts payable; and $293,000 in other items. There were also real estate mortgages exceeding $10,000,000, and substantial arrearages in real estate taxes. Messrs. Lee and J. J. Shubert owned, directly or indirectly, 34% of Shubert's outstanding stock, 9.7% of the outstanding debentures, and in excess of 40% of the remaining indebtedness (other than real estate mortgages and taxes). (Pet. 33-34.)

In April, 1932, in order to provide funds for payment of administration and operating expenses, the receivers pursuant to court order issued $300,000 of receiver's certificates, maturing not later than March 1, 1933.[1] The authorizing order provided, among other

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[1] The receivers were authorized, by agreement with the holders of the certificates, to extend the maturity date for

things, that the certificates should be secured by a lien upon all assets in the receivers' possession, prior and superior to the gold debentures and unsecured debts, but subordinate to valid liens existing at the date of the receivers' appointment and to administration expenses; that the certificates should not (unless defaulted when due) limit the right of the receivers to dispose of any assets in their hands and apply the proceeds to payment of administration expenses; that the certificates, at the election of the holders, should become due and payable upon any sale of assets and termination of the receivership, or in the event Shubert should be adjudged bankrupt. (Pet. 34-35, 39.)

The entire issue of certificates was sold to the Atel Company, Inc., a newly organized corporation wholly-owned by Dorsar Enterprises, Inc., which in turn was wholly-owned by the Shuberts individually. The money Atel used to purchase the certificates was a loan from the Shuberts to Dorsar to Atel. (Pet. 35-36.)

Efforts to effect a reorganization were unsuccessful, and Shubert's assets continued to dwindle. Hence, on January 21, 1933, a decree was entered in the receivership proceedings directing that Shubert's assets be sold to the highest bidder, with an upset price of $400,000 fixed for bulk sale. It was provided that any creditor, stockholder, or officer of Shubert might bid in his own right, including Lee Shubert if he resigned as receiver prior to the sale. It was fur-

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a period not exceeding three months from March 1, 1933. (Pet. 35.)

ther provided that no sale should be confirmed to any purchaser for a corporation organized to become the owner of the assets pursuant to a plan of reorganization, unless such plan was theretofore approved by the court. And finally, it was provided that part of the purchase price might be paid by delivery of receivers' certificates or other claims. (Pet. 36-37.)

Lee Shubert thereafter resigned as a receiver, and secured a postponement of the sale to April 7, 1933, by undertaking to bid, or cause to be bid, not less than $400,000 for the assets. On April 5, 1933, Select Theatres Corporation, the taxpayer herein, was organized as a subsidiary of Atel, and acquired the receivers' certificates from Atel in the form of a loan. Two days later, on April 7, the sale was held and the assets were struck down to taxpayer, the only bidder, for $400,000. The confirmatory decree authorized the Special Master to accept the receivers' certificates from taxpayer as *pro tanto* payment of the purchase price, and noted further that taxpayer had not been organized to become owner of the Shubert assets pursuant to any plan or agreement of reorganization. Thereafter, the sale was consummated by delivery of the receivers' certificates duly endorsed, plus $90,009.52 in cash (a loan from the Shubert partnership to Dorsar to Atel to taxpayer) representing the difference between the purchase price and the principal amount of the receivers' certificates plus accrued interest. The cash proceeds of the sale were applied to the payment of administration expenses, after which nothing remained for distribution to the creditors or stockholders of Shubert. (Pet. 37-39.)

On May 31, 1933, Lee Shubert wrote a letter to Shubert's creditors and stockholders. Noting that a plan of reorganization had fallen through prior to the sale of Shubert assets to taxpayer, and that Shubert's creditors would receive little or nothing out of the proceeds of the sale, he expressed his earnest desire that those who invested their money in Shubert should have an opportunity to participate in the new company. Hence, he stated, he had arranged for issuance of 50% of the common stock of taxpayer (after a described recapitalization) to security holders and creditors of Shubert, without cost to them. This stock, the greater part of which would otherwise have become part of Lee Shubert's personal holdings, was to be distributed, in prescribed ratios, in exchange for debentures, allowed claims, and stock of Shubert. (Pet. 39-41.)

In response to Mr. Shubert's offer, over 86% of Shubert's debentures, over 63% of its allowed claims, and over 82% of its outstanding stock were surrendered in exchange for common stock of the taxpayer. As a result of such exchanges, an aggregate of 79,731 shares of taxpayer's common stock (out of a total of 200,000 shares, par value 10 cents per share) were issued to Shubert's creditors and stockholders. (Pet. 42.)

The basis in the hands of Shubert of the assets purchased by taxpayer at the sale on April 7, 1933, was upwards of $4,000,000. (Pet. 32.)

This litigation was instituted to recover excess profits taxes paid for the fiscal year ended June 30, 1943. In the consolidated income and excess profits tax return for that year filed by taxpayer and its

subsidiaries, the excess profits credit was computed under the invested capital method provided by Section 714, *et seq.*, of the Internal Revenue Code of 1939. And in this computation, taxpayer treated the amount it paid for the Shubert assets ($400,000) as its invested capital. In seeking refund, taxpayer now contends that it was entitled to adopt the basis of the assets in the hands of Shubert ($4,000,000) in determining its invested capital. (Pet. 30-32.)

ARGUMENT

1. The controlling question is whether taxpayer acquired the assets of an insolvent corporation (Shubert) in a tax-free reorganization under Section 112 (b)(4) and (i) of the Revenue Act of 1932, *supra*, pp. 2-3.[2] The courts below answered this question in

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[2] If so, taxpayer is entitled to adopt the basis of the assets in the hands of Shubert ($4,000,000), rather than the amount it paid at auction for the assets ($400,000), in computing its excess profits credit for the tax year in question. In the computation of equity invested capital for the purposes of the excess profits credit, Section 718(a)(2) of the 1939 Code, *supra*, pp. 4-5, entitled the taxpayer to include "Property * * * paid in * * * for stock, * * * in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange." Section 113(a) of the same Code governs the basis (unadjusted) for determining gain or loss, and subsection (a)(12), *supra*, p. 4, provides that the unadjusted basis of property acquired between 1913 and 1934, if prescribed by Section 113(a)(6), (7), or (9) of the Revenue Act of 1932, shall be as therein prescribed. Section 113(a)(7) of the 1932 Act, *supra*, p. 3, provides for substitution of basis if there is a tax-free reorganization, and if other conditions are met. Section 112(i) of the 1932 Act, *supra*, pp. 2-3, defines the term "reorganization" as including, among other things, the acquisition by one corporation of substantially all of the properties of another. Since a re-

the negative primarily on the ground that, although there was literal compliance with the statutory requirements, there was a lack of the continuity of proprietary interest required for a valid reorganization under decisions of this Court, notably *Helvering* v. *Limestone Co.*, 315 U.S. 179, and *Palm Springs Corp.* v. *Commissioner*, 315 U.S. 185. Far from being in conflict with those and related decisions, as taxpayer asserts (Pet. 12-16), the decision below is in complete accord with them. In any event, the decision below raises no question of general importance, and its significance is limited to the particular circumstances here presented.

The continuity of interest requirement may be briefly formulated as follows: Where one corporation transfers its assets to another, the transaction does not constitute a valid reorganization unless the proprietors of the transferor retain a substantial proprietary stake in the transferee, and unless the retained interests represent a substantial part of the value of the assets transferred. *LeTulle* v. *Scofield*, 308 U.S. 415; *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378; *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462. If the transferor is solvent its proprietors are, of course, its stockholders, and hence they must receive a substantial proprietary stake in the new cor-

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organization is not automatically tax-free, but must qualify as such under one of the provisions of Section 112(b), the final provision relevant here is Section 112(b)(4) of the 1932 Act, *supra*, p. 2, which provides that no gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

poration. However, if the transferor is insolvent the problem of identifying its proprietors as of the time of transfer is more difficult. *Helvering* v. *Limestone Co.*, *supra*, involved a bankruptcy sale of corporate assets to a committee of the creditors who, in turn, transferred the assets to a new corporation in exchange for its stock, pursuant to a plan of reorganization. This Court held that the continuity of interest test was satisfied because the creditors of the old corporation were not only the proprietors of the new, but had become the proprietors of the old, prior to the bankruptcy sale. More particularly, it was held that the equity ownership of an insolvent corporation shifts from its stockholders to its creditors when the creditors take steps to enforce their demands against the corporation. And in the case before it, the Court ruled that the shift occurred upon the institution of bankruptcy proceedings.

It is abundantly clear from the opinion in *Limestone Co.*, *supra*, and in the related cases of *Palm Springs Corp.* v. *Commissioner*, *supra*, and *Bondholders Committee* v. *Commissioner*, 315 U.S. 189, that the equity ownership of a corporation does not shift to its creditors, whether secured or unsecured, solely by virtue of the insolvency of the corporation. The shift occurs only when the creditors establish effective command over the assets by taking the steps necessary to oust the stockholders from control. Whether such effective command has been secured by the creditors prior to the transfer of assets is a question which depends upon the peculiar circumstances of each case. In *Limestone Co.*, the Court dated the shift of equity ownership from the initiation of bank-

ruptcy proceedings. In *Palm Springs Corp.* and *Bondholders Committee*, the shift was deemed to occur when bondholders initiated foreclosure sales. Under other circumstances, other procedures might be deemed sufficient. But, at all events, the creditors must, by overt action, take the helm of the old corporation and effectively control the disposition of its assets.

In the case at bar, th courts below have concluded that the taxpayer, albeit the stockholder-proprietor of the new corporation, was not the proprietor of the old at the time of the auction sale merely by reason of the acquisition of receivers' certificates. This determination was essentially factual. Full cognizance was taken of the controlling criteria (Pet. 44-48), and we submit that they were correctly applied. Furthermore, in view of the detailed and closely-reasoned opinion of the District Court, adopted by the Court of Appeals, we believe it will suffice here to advert to the following principal reasons why the taxpayer errs in contending that it became the proprietor of the old corporation prior to the auction sale: (1) As a holder of receivership certificates taxpayer was not even a creditor of the old corporation (Shubert) but simply a creditor of the receivers with carefully delimited rights against the receivership assets; (2) The receivers' certificates were not even due, much less in default, at the time of the auction sale--and, in fact, they were satisfied in full by their application to the purchase price; (3) It follows that taxpayer was never in a position to take the necessary steps, nor did it purport to take such steps, to secure effective command over the assets of Shubert

prior to the auction sale. Without more, it is clear that the conclusion of the courts below was not only in accord with, but was required by, the relevant decisions of this Court.

2. Taxpayer also asserts a conflict between the ruling of the courts below and the decision in *Minneapolis, N. & S. Ry.* v. *Kelm*, 117 F. Supp. 325 (Minn.), affirmed, 225 F. 2d 909 (C.A. 8th). That case is plainly distinguishable. There an insolvent railroad went into receivership, and the holders of collateral trust notes commenced foreclosure proceedings to liquidate the railroad properties, thus assuming effective command of the corporation's assets. Thereafter, and prior to the foreclosure sale, the holders of the notes assigned all of their rights to other parties for valuable consideration, and the assignees purchased the assets at the sale and transferred them to a new corporation in exchange for stock. On these facts, it was held that the requisite continuity of interest was present, the assignees of the notes being regarded as standing in the place of the assignors—who had theretofore acquired the equity ownership of the old corporation. In the case at bar, taxpayer did not succeed, by assignment or otherwise, to the rights of the creditors of the old corporation; it had only certain prescribed rights as a creditor of the receivers. Furthermore, its claims as such creditor were, in effect, paid in full when due.

3. Taxpayer also asserts a conflict with the decision in *Northern Pacific Ry.* v. *Boyd*, 228 U.S. 482, which established the full priorities rule. So far as that rule is relevant, it has been drawn into the

continuity of interest test by the decision in *Limestone Co.*, which cites it (p. 183) as giving creditors of an insolvent corporation the right to exclude the stockholders from the reorganization plan. But *Limestone Co.* also holds that this right must be affirmatively exercised by the creditors in order to shift the proprietary interest for the purpose of the continuity test. Since taxpayer was not a creditor of the old corporation to begin with, and never took (nor could take) the necessary steps to assume effective command of the assets, *Northern Pacific Ry.* is inapplicable.[3]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MARCH, 1958.

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[3] The fact that the old creditors and stockholders of Shubert later received some of the common stock of the taxpayer is irrelevant. As the District Court pointed out (Pet. 53-55), the record is clear that they received the stock as a gratuity, and not (save by way of formality) in exchange for their claims.

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